

DRAFT

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA
CA-20
ENERGY DIVISION **RESOLUTION E-3826**
May 22, 2003

R E S O L U T I O N

Resolution E-3826. San Diego Gas & Electric Company requests approval of its investment management agreement with UBS Global Asset Management (Americas) Inc. Request approved.

By Advice Letter 1481-E Filed on March 27, 2003

SUMMARY

This Resolution approves the investment management agreement (Agreement) between the San Diego Gas & Electric Company (SDG&E) Nuclear Facilities Decommissioning Master Trust Committee (Committee) and UBS Global Asset Management (Americas) Inc. (UBS), and authorizes the Commission's Executive Director or his designee to sign the Agreement on behalf of the Commission.

BACKGROUND

In Order Instituting Investigation No. 86, the Commission conducted an extensive investigation, on its own motion, into the recovery of costs of decommissioning nuclear power plants owned by the California utilities. In Decision (D.) 87-05-062, the Commission adopted externally managed trust funds as vehicles for accruing decommissioning funds. In that decision, the Commission also established guidelines for trust agreements.

In response to D.87-05-062, SDG&E established two trusts; one to hold contributions which qualify for an income tax deduction under Section 468A of Internal Revenue Code (Qualified Trust) and another to hold the remaining funds (Non-qualified Trust). By Resolution E-3060, dated November 25, 1987, the Commission approved SDG&E trust agreements.

As of December 31, 2002, the total market value of the Trusts was \$494 million.



Section 3.01 of both trust agreements provides for the establishment of the Committee. Subject to Commission approval, the Committee is authorized to appoint one or more investment managers to direct investments of all or part of the trusts' assets. To direct the investment of the trusts, the Commission has so far approved the Committee's appointments of Delaware Investment Advisors, Brown Brothers Harriman & Company, NISA Investment Advisors, Payden & Rygel, and TCW Asset Management Company as *fixed-income* (i.e., bonds and commercial paper) managers; and Fidelity Management Trust Company, State Street Global Advisors (State Street), and Deutsche Asset Management (Deutsche) as *equity* (i.e., company shares) managers.

The Commission has set forth its limitations on the nuclear utilities' trust fund investments in a series of decisions. Most recently, D.95-07-055 authorized that up to 50% of the fair market value of Qualified Trust funds may be invested in publicly traded equity securities. Of these, 40% may be invested in non-U.S. equity securities. In authorizing the international equity allocation, the Commission recognized the benefit of diversifying a portfolio through international equities to increase returns and reduce risk.

In its meeting on February 26, 2003, the Committee approved retaining UBS as an international equity investment manager under the Qualified Trust and authorized the execution of an investment management agreement between UBS and the Committee.

The Committee approved the UBS appointment to replace Deutsche as a non-U.S. equity manager of the Qualified Trust. Deutsche was hired on July 18, 2001. The decision to replace Deutsche was based on recent changes in its management, investment process, and poor portfolio returns. Due to reorganization of Deutsche, portfolio managers were changed during June of 2002. Moreover, from the time it was hired until December 31, 2002, Deutsche's portfolio returns had lagged the Morgan Stanley Capital International Index benchmark by 2 percent.

If approved by the Commission, UBS would manage the non-U.S. equity allocation about equally with State Street.

SDG&E conducted a search of 22 reputable investment managers to identify a replacement for Deutsche. The list was narrowed down to three managers as explained in attachment A of AL 1481-E. SDG&E chose UBS as an international



equity manager from the three finalists who had strong performance against the Morgan Stanley Capital International Index. Managers were evaluated based on tracking error, turnover, information ratio, investment style, absolute return, risk control, personnel, and investment process. Background information on UBS's investment performance, investment process, and personnel is attached as Exhibit 3 to AL 1481-E.

The proposed Agreement between the Committee and UBS is substantially the same as the Agreements previously approved by the Commission, with the exception of fee schedules, which can be found in Appendix B to the proposed Agreement. The fee schedules comply with those ordered in D.87-05-062 and subsequently in D.95-07-055.

D.95-07-055 also provides for the Agreements to be approved through the Commission's Advice Letter process.

In conformance with D.95-07-055, SDG&E requests Commission approval to hire UBS as one of its international equity advisors to replace Deutsche.

NOTICE

Notice of AL 1481-E was made by publication in the Commission's Daily Calendar. SDG&E states that a copy of the Advice Letter was mailed and distributed in accordance with Section III-G of General Order 96-A.

PROTESTS

Advice Letter AL 1481-E was not protested.

DISCUSSION

According to SDG&E, State Street currently manages about \$37 million of the foreign equity securities in the Qualified Trust in a *tax-advantaged* strategy – one that matches realized capital gains with realized capital losses to reduce taxable gains. The company has performed well compared to the Morgan Stanley Index.

Deutsche manages some \$31 million in an *active strategy* – whereby the investment manager tries to exceed the Morgan Stanley benchmark.



Investment performance returns compiled by Russell/Mellon Analytical Services, LLC, states that active strategy by foreign equity managers have outperformed the Morgan Stanley Index by 1.40% annually over 3 years and 2.34% over 5 years for the period ending December 31, 2002. However, from the time it was hired until December 31, 2002, Deutsche's portfolio returns had lagged the Morgan Stanley Capital International Index benchmark by 2 percent.

SDG&E accordingly proposes that UBS take over management of the investment account currently managed by Deutsche. The end result would have State Street managing about \$37 million in a tax-advantaged strategy that matches the Morgan Stanley Index benchmark, and UBS managing the remaining \$31 million in an active strategy. UBS has managed an active foreign equity strategy since December 31, 1981 and has surpassed the Morgan Stanley Index by 2.89% per year on an annualized basis.

SDG&E wishes to continue retaining State Street because of their contribution to the Trusts' investment objectives of diversification into international equities.

SDG&E requests Commission approval of the Agreement with UBS so that the Qualified Trust may be invested within the levels authorized by the Commission and to achieve appropriate diversification among non-U.S. equity managers to maximize after-tax returns on a risk-adjusted basis.

The Energy Division has reviewed SDG&E's AL 1481-E and believes that the proposed Agreement is in compliance with the applicable Commission requirements and the changes will be beneficial to the ratepayers as well as the shareholders of SDG&E. Accordingly, the Energy Division recommends approval of the request by authorizing the Executive Director, or his designee, to sign the Agreement on behalf of the Commission.

COMMENTS

This is an uncontested matter in which the resolution grants the relief requested. Accordingly, pursuant to PU Code 311(g)(2), the otherwise applicable 30-day period for public review and comment is being waived.

FINDINGS

1. SDG&E filed AL 1481-E on March 26, 2003 requesting approval of its investment management agreement (Agreement) with UBS Global Asset Management (Americas) Inc. (UBS).
2. In D.87-05-062, the Commission required externally managed trust funds to finance the decommissioning of nuclear power plants.
3. D.95-07-055 requires that all Agreements be approved by the Commission through the advice letter process.
4. In its February 26, 2003 meeting, SDG&E's Nuclear Facilities Decommissioning Master Trust Committee (Committee) approved retaining UBS as an international equity investment manager under the Qualified Trust.
5. The proposed Agreement between the Committee and UBS is substantially the same as the Agreements previously approved by the Commission, with the exception of the fee schedule.
6. The proposed Agreement is in compliance with applicable Commission requirements and should be approved.

THEREFORE IT IS ORDERED THAT:

1. San Diego Gas & Electric Company's Advice Letter 1481-E is approved.
2. The Commission's Executive Director, or his designee, is authorized to sign the Agreement on behalf of the Commission.

This Resolution is effective today.

I certify that the foregoing resolution was duly introduced, passed and adopted at a conference of the Public Utilities Commission of the State of California held on May 22, 2003; the following Commissioners voting favorably thereon:

WILLIAM AHERN
Executive Director